

***Universal Service
Administrative Company
("USAC")***

*Audited Financial Statements for the
Years Ended December 31, 2003 and 2002 and
Independent Auditors' Report*

UNIVERSAL SERVICE ADMINISTRATIVE COMPANY

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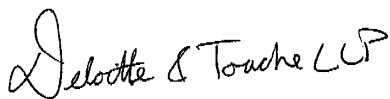
INDEPENDENT AUDITORS' REPORT

To the Board of Directors of the
Universal Service Administrative Company

We have audited the accompanying statements of financial position of the Universal Service Administrative Company (a Delaware corporation) (the "Company") as of December 31, 2003 and 2002, and the related statements of operations and change in unrestricted net assets and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Universal Service Administrative Company as of December 31, 2003 and 2002, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

A handwritten signature in cursive script that reads "Deloitte & Touche LLP".

June 23, 2004

UNIVERSAL SERVICE ADMINISTRATIVE COMPANY

STATEMENTS OF FINANCIAL POSITION

DECEMBER 31, 2003 AND 2002

(In thousands)

ASSETS	2003	2002
CURRENT ASSETS:		
Cash and cash equivalents (Note 2)	\$ 2,886	\$ 514
Receivable from Federal Universal Service Fund ("USF") (Note 2)	-	2,480
Interest receivable	6	7
Prepaid expenses and other current assets	<u>739</u>	<u>589</u>
	3,631	3,590
ASSETS HELD FOR FEDERAL USF (Note 3)	<u>3,491,094</u>	<u>2,881,616</u>
Total current assets	3,494,725	2,885,206
FIXED ASSETS, less accumulated depreciation and amortization of \$894 and \$762, respectively (Note 2)	2,009	584
OTHER ASSETS	<u>80</u>	<u>-</u>
TOTAL ASSETS	<u>\$ 3,496,814</u>	<u>\$ 2,885,790</u>
LIABILITIES AND UNRESTRICTED NET ASSETS		
CURRENT LIABILITIES:		
Accounts payable and accrued expenses (Note 2)	\$ 2,938	\$ 4,174
Payable to Federal Universal Service Fund ("USF") (Note 2)	2,782	-
LIABILITIES RELATED TO ASSETS HELD FOR FEDERAL USF (Note 3)	<u>3,491,094</u>	<u>2,881,616</u>
Total current liabilities	3,496,814	2,885,790
COMMITMENTS AND CONTINGENCIES (Note 6)		
UNRESTRICTED NET ASSETS	<u>-</u>	<u>-</u>
TOTAL LIABILITIES AND UNRESTRICTED NET ASSETS	<u>\$ 3,496,814</u>	<u>\$ 2,885,790</u>

See notes to financial statements.

UNIVERSAL SERVICE ADMINISTRATIVE COMPANY

STATEMENTS OF OPERATIONS AND CHANGE IN UNRESTRICTED NET ASSETS YEARS ENDED DECEMBER 31, 2003 AND 2002 (In thousands)

	2003	2002
REVENUE—		
Contract revenue	<u>\$ 58,791</u>	<u>\$ 46,192</u>
OPERATING EXPENSES:		
Contractual expenses (Notes 1 and 6)	41,356	36,438
Personnel and related expenses	8,771	5,502
General and administrative	8,335	3,402
Depreciation and amortization	<u>329</u>	<u>850</u>
Total operating expenses	<u>58,791</u>	<u>46,192</u>
NET INCOME	-	-
UNRESTRICTED NET ASSETS—Beginning of year	<u>-</u>	<u>-</u>
UNRESTRICTED NET ASSETS—End of year	<u>\$ -</u>	<u>\$ -</u>

See notes to financial statements.

UNIVERSAL SERVICE ADMINISTRATIVE COMPANY

STATEMENTS OF CASH FLOWS

YEARS ENDED DECEMBER 31, 2003 AND 2002

(In thousands)

	2003	2002
CASH FLOWS FROM OPERATING ACTIVITIES:		
Cash received from contributors	\$ 5,889,298	\$ 5,174,622
Interest received	26,063	44,811
Cash paid to service providers	(5,358,946)	(5,195,897)
Cash paid for administrative costs	(59,928)	(47,709)
Less: Net cash (provided by) used for Federal USF	<u>(492,361)</u>	<u>22,479</u>
Net cash provided by (used for) operating activities	<u>4,126</u>	<u>(1,694)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Redemption of investments	320,538	588,342
Purchase of investments	(389,855)	(431,761)
Cash paid for fixed assets	(1,754)	(387)
Less: Net cash used for (provided by) Federal USF	<u>69,317</u>	<u>(156,581)</u>
Net cash used for investing activities	<u>(1,754)</u>	<u>(387)</u>
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	2,372	(2,081)
CASH AND CASH EQUIVALENTS—Beginning of year	<u>514</u>	<u>2,595</u>
CASH AND CASH EQUIVALENTS—End of year	<u>\$ 2,886</u>	<u>\$ 514</u>
RECONCILIATION OF NET CASH FROM OPERATING ACTIVITIES:		
Net income	\$ -	\$ -
Adjustments to reconcile net income to net cash provided by (used for) operating activities:		
Depreciation and amortization	329	850
Changes in operating assets and liabilities:		
(Increase) decrease in interest receivable	1	(1)
Decrease (increase) in prepaid expenses and other current assets	(230)	763
Decrease (increase) in assets held for Federal USF	(609,478)	(1,247)
Decrease (increase) in receivable from/payable to Federal USF	5,262	(176)
Decrease in accounts payable and accrued expenses	(1,236)	(3,130)
(Decrease) increase in liabilities related to assets held for Federal USF	<u>609,478</u>	<u>1,247</u>
NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES	<u>\$ 4,126</u>	<u>\$ (1,694)</u>

See notes to financial statements.

UNIVERSAL SERVICE ADMINISTRATIVE COMPANY

NOTES TO FINANCIAL STATEMENTS YEARS ENDED DECEMBER 31, 2003 AND 2002 (In thousands)

1. ORGANIZATION AND BASIS OF PRESENTATION

The Universal Service Administrative Company ("USAC" or the "Company") was incorporated, effective September 17, 1997, as a not for profit independent wholly-owned subsidiary of the National Exchange Carrier Association, Inc. ("NECA"), and appointed by the Federal Communications Commission ("FCC") to administer the Federal Universal Service Fund ("USF"). USAC's Board of Directors consists of independent directors representing a cross-section of stakeholders in the Federal USF.

The FCC, in its Report and Order in CC Docket Nos. 96-45 and 97-21 ("Universal Service Order") released May 8, 1997 and November 20, 1998, respectively, determined that USAC should serve as the permanent administrator of the high cost, low income, rural health care, and schools and libraries universal service support mechanisms, collectively referred to herein as the "Support Mechanisms," established pursuant to Section 254 of the Communications Act of 1934, as amended.

USAC performs billing, collection and disbursement functions for all the Support Mechanisms. It also collects information regarding contributing entities' and end-user telecommunications revenues, submits projections of demand, administrative expenses for the Support Mechanisms and quarterly universal service contribution data to the FCC.

The functions of USAC also include, but are not limited to: development of applications and associated instructions as needed for the Support Mechanisms, administering the application process to ensure compliance with FCC rules and regulations, creating and maintaining a web site and related operational infrastructure for such processes, performing outreach and public education functions, authorizing audits of telecommunication carriers, schools, libraries, and rural health care providers, and development and implementation of other functions unique to the Support Mechanisms.

Funds collected from contributors by USAC are restricted as to their intended use related to the Support Mechanisms discussed above. Accordingly, such funds have been reflected as assets held for Federal USF and liabilities related to assets held for Federal USF in the accompanying statements of financial position. Available funds are maintained and invested by USAC.

NECA performs certain administrative services for USAC under contract whereby NECA is compensated by USAC in accordance with NECA's Cost Accounting and Procedures Manual. Effective July 1, 2002, NECA entered into a fixed price contract with USAC for services performed for the Schools and Libraries and Rural Health Care Support Mechanisms. For the years ended December 31, 2003 and 2002, the expense recognized for services rendered by NECA were \$35,923 and \$32,909, respectively, and is included in contractual expenses in the accompanying statements of operations. At December 31, 2003 and 2002, the amounts due to NECA related to these services were \$731 and \$3,006, respectively.

UNIVERSAL SERVICE ADMINISTRATIVE COMPANY

NOTES TO FINANCIAL STATEMENTS YEARS ENDED DECEMBER 31, 2003 AND 2002 (In thousands)

2. ACCOUNTING POLICIES

Use of Estimates—The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The allowance for doubtful accounts represents a reserve estimate for amounts billed to contributors that may be uncollectible. The allowance includes specific reserves for identified bankruptcies, identified inactive contributors, delinquent amounts that were referred to the FCC for enforcement and a general reserve based on management's assessment of the recoverability of accounts receivable. Management periodically reviews such estimates and it is reasonably possible that management's assessment of recoverability may change based on actual results.

Concentration of Credit Risk—Financial instruments that potentially subject the Company to concentration of credit risk consist principally of cash, cash equivalents, short-term and long-term investments and receivables from contributors. The Company places its cash, cash equivalents, short-term and long-term investments with high-credit, quality institutions and limits the amount of credit exposure from any one institution. The Company's accounts receivable arise from amounts billed to contributors but unpaid. The Company performs ongoing evaluations of the recoverability of the receivables and provides allowances for amounts that may be uncollectible. In addition, the Company has improved enforcement by referring delinquent obligations to the FCC.

Cash and Cash Equivalents—USAC considers all highly liquid securities, purchased with an original maturity of three months or less, to be cash equivalents.

Short-Term Investments—USAC considers all securities purchased with an original maturity greater than three months but less than or equal to one year to be short-term investments. Short-term investments consist primarily of investment grade marketable debt securities with readily determinable fair values all of which are classified as held-to-maturity. The Company accounts for its investments in accordance with Statement of Financial Accounting Standards ("SFAS") No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*. Under SFAS No. 124, a not for profit organization reports investments in debt and equity securities at fair market value.

Long-Term Investments—USAC considers all securities purchased with an original maturity greater than one year to be long-term investments. Long-term investments consist primarily of investment grade marketable debt securities with readily determinable fair values all of which are classified as held-to-maturity. The Company accounts for its investments in accordance with Statement of Financial Accounting Standards ("SFAS") No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*. Under SFAS No. 124, a not for profit organization reports investments in debt and equity securities at fair market value.

Fixed Assets—Fixed assets consist of furniture, equipment, leasehold improvements and software and are carried at cost. Depreciation of furniture and equipment is calculated on a straight-line basis

UNIVERSAL SERVICE ADMINISTRATIVE COMPANY

NOTES TO FINANCIAL STATEMENTS YEARS ENDED DECEMBER 31, 2003 AND 2002 (In thousands)

over the five to seven year estimated useful lives of those assets. Amortization of leasehold improvements is calculated on a straight-line basis over the remaining period of the respective leases or estimated useful lives of the improvements, whichever is less. Amortization of software is calculated on a straight-line basis over the three year estimated useful lives of those assets. Maintenance and repairs are expensed to operations as incurred.

Impairment of Long-Lived Assets—The Company evaluates long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may no longer be recoverable. If the estimated future cash flows (undiscounted and without interest charges) from the use of an asset were less than the carrying value, a write-down would be recorded to reduce the related asset to its estimated fair value.

Receivable from/Payable to Federal USF—Receivable from USF presented on the USAC statements of financial position consists of amounts owed USAC from the USF for accounts payable and accrued expenses incurred by USAC net of assets available to satisfy those obligations. Payable to USF consists of net assets in excess of accounts payable and accrued expenses.

Contract Revenue—USAC recognizes contract revenue when services are rendered. Contract revenues are equal to the cost of providing administrative support to the Support Mechanisms.

Amounts Billed to Contributors—Contributors to the USF are permitted to revise their revenue data, which may result in adjustments to amounts previously billed. Billing adjustments are calculated upon receipt of the revised revenue data and recorded when billed or credited to the contributor. The Company accrues known and unbilled adjustments resulting from revised revenue data received from the contributors before year-end.

Payable to Service Providers—Payable to service providers reflects amounts that have been approved for payment by the various Support Mechanisms but have not yet been disbursed. The Company recognizes the obligation upon review and approval of the submitted payment requests as specified in the Support Mechanism rules.

Payable to Contributors—Payable to contributors represents contributors' credit balances primarily due to overpayments and other adjustments.

Amounts Paid and Due to Service Providers—Amounts paid and due to service providers are presented as a gross amount. However, during 2003 and 2002, service providers receiving support from Schools and Libraries Support Mechanism had the option to net their support due from Schools and Libraries Support Mechanism against their payments relating to all four of the Support Mechanisms comprising USF. It is mandatory that providers receiving support from the Rural Health Care Support Mechanism net their support due against their payments to USF. There is no provision that enables providers to net their support due from High Cost and Low Income Support Mechanisms against their contributions to USF.

Amounts paid and due to service providers through certain Support Mechanisms are based on estimates and provider data that may be subject to subsequent revisions. These revisions may result in adjustments to amounts previously billed or disbursed. In accordance with FCC Rules and

UNIVERSAL SERVICE ADMINISTRATIVE COMPANY

NOTES TO FINANCIAL STATEMENTS YEARS ENDED DECEMBER 31, 2003 AND 2002 (In thousands)

Regulations, the Company records these adjustments in the period they are determined. Management does not believe that the impact of these adjustments is material to the financial statements presented.

Statements of Cash Flows—The statements of cash flows include all cash flow activity relating to USAC and the Support Mechanisms.

Reclassifications—Certain reclassifications were made to the prior year financial statements to conform to the current year presentation.

3. ASSETS HELD FOR FEDERAL USE AND LIABILITIES RELATED TO ASSETS HELD FOR FEDERAL USE

In connection with USAC's administration of the Support Mechanisms (Note 1), USAC collects monies and makes disbursements between various telecommunications providers, as specified by the FCC. The following summary financial information applicable to Federal USE is provided for additional information.

UNIVERSAL SERVICE ADMINISTRATIVE COMPANY

NOTES TO FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2003 AND 2002
(In thousands)

Summary Statements of Assets and Liabilities Applicable to Federal USF	2003					2002				
	High Cost	Low Income	Schools & Libraries	Rural Health Care	Total USF	High Cost	Low Income	Schools & Libraries	Rural Health Care	Total USF
ASSETS:										
Restricted cash and cash equivalents	\$ 89,756	\$ 50,166	\$ 2,352,503	\$ 16,250	\$ 2,508,675	\$ 101,212	\$ 47,713	\$ 1,923,830	\$ 12,876	\$ 2,085,631
Investments (Note 2)	-	-	344,459	-	344,459	-	-	275,141	-	275,141
Receivable from contributors	400,863	89,443	275,937	4,695	770,939	331,632	74,798	230,191	3,636	640,257
Allowance for doubtful accounts (Note 2)	(70,105)	(16,394)	(52,767)	(636)	(139,902)	(59,436)	(15,184)	(46,961)	(1,476)	(123,057)
Interest receivable	17	41	4,075	8	4,141	86	53	3,489	16	3,644
Receivable from USAC	99	579	2,053	51	2,782	-	-	-	-	-
TOTAL ASSETS	\$ 420,630	\$ 123,835	\$ 2,926,260	\$ 20,368	\$ 3,491,094	\$ 373,494	\$ 107,380	\$ 2,385,690	\$ 15,052	\$ 2,881,616
LIABILITIES:										
Payable to service providers	\$ 276,818	\$ 55,780	\$ 9,434	\$ 19	\$ 342,051	\$ 278,320	\$ 52,602	\$ 20,446	\$ -	\$ 351,368
Payable to contributors	19,453	4,349	12,945	158	36,904	19,468	4,250	12,773	219	36,710
Payable to USAC	-	-	-	-	-	(146)	(127)	2,692	61	2,480
TOTAL LIABILITIES	\$ 296,271	\$ 60,129	\$ 22,379	\$ 177	\$ 378,955	\$ 297,642	\$ 56,725	\$ 35,911	\$ 280	\$ 390,558

UNIVERSAL SERVICE ADMINISTRATIVE COMPANY

NOTES TO FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2003 AND 2002
(In thousands)

Summary Statements of Changes in Assets and Liabilities Applicable to Federal USF	2003					2002				
	High Cost	Low Income	Schools & Libraries	Rural Health Care	Total USF	High Cost	Low Income	Schools & Libraries	Rural Health Care	Total USF
ADDITIONS:										
Amounts billed to contributors	\$ 3,204,654	\$ 697,528	\$ 2,143,630	\$ 28,333	\$ 6,074,145	\$ 2,548,280	\$ 627,475	\$ 2,065,543	\$ 27,386	\$ 5,268,684
Interest income	546	549	25,336	129	26,560	511	666	40,131	262	41,570
Total additions	3,205,200	698,077	2,168,966	28,462	6,100,705	2,548,791	628,141	2,105,674	27,648	5,310,254
DEDUCTIONS:										
Amounts paid and due to service providers	3,265,140	711,733	1,409,937	21,883	5,408,693	2,976,294	675,912	1,660,196	16,850	5,329,252
Allowance for doubtful accounts	8,190	656	4,155	(861)	12,140	6,336	2,884	6,061	947	16,228
Operating expenses	12,118	3,175	40,945	2,553	58,791	6,852	1,870	34,387	3,083	46,192
Total deductions	3,285,448	715,564	1,455,037	23,574	5,479,624	2,989,482	680,666	1,700,644	20,880	5,391,672
INTERPROGRAM TRANSFER (Note 5)	128,757	30,538	(159,827)	531	-	388,466	57,093	(445,550)	(9)	-
CHANGE IN ASSETS AND LIABILITIES	\$ 48,508	\$ 13,051	\$ 554,102	\$ 5,419	\$ 621,081	\$ (52,225)	\$ 4,568	\$ (40,520)	\$ 6,759	\$ (81,418)

UNIVERSAL SERVICE ADMINISTRATIVE COMPANY

NOTES TO FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2003 AND 2002
(In thousands)

Summary Statements of Cash Flows Applicable to Federal USF	2003					2002				
	High Cost	Low Income	Schools & Libraries	Rural Health Care	Total USF	High Cost	Low Income	Schools & Libraries	Rural Health Care	Total USF
CASH FLOWS FROM OPERATING ACTIVITIES:										
Cash received from contributors	\$ 3,106,067	\$ 676,789	\$ 2,079,479	\$ 26,963	\$ 5,889,298	\$ 2,499,739	\$ 600,202	\$ 2,049,909	\$ 24,772	\$ 5,174,622
Cash paid to service providers	(3,234,823)	(701,808)	(1,400,722)	(21,593)	(5,358,946)	(2,887,085)	(663,090)	(1,629,281)	(16,441)	(5,195,897)
Cash paid to USAC for administrative expenses	(12,044)	(3,620)	(45,611)	(2,660)	(63,935)	(6,185)	(1,703)	(34,776)	(3,220)	(45,884)
Intraprogram transfers (Note 5)	128,757	30,538	(159,826)	531	-	388,466	57,093	(445,550)	(9)	-
Net cash (used for) provided by operating activities	(114,567)	2,453	497,990	3,374	492,361	(3,613)	(6,059)	(18,176)	5,369	(22,479)
CASH FLOWS FROM INVESTING ACTIVITIES:										
Redemption of investments	-	-	320,538	-	320,538	-	-	588,342	-	588,342
Purchase of investments	-	-	(389,855)	-	(389,855)	-	-	(431,761)	-	(431,761)
Net cash (used for) provided by investing activities	-	-	(69,317)	-	(69,317)	-	-	156,581	-	156,581
CASH FLOWS FROM FINANCING ACTIVITIES	-	-	-	-	-	-	-	-	-	-
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(11,456)	2,453	428,673	3,374	423,044	(3,613)	(6,059)	138,405	5,369	134,102
CASH AND CASH EQUIVALENTS— Beginning of year	101,212	47,713	1,923,830	12,876	2,085,631	104,825	53,772	1,785,425	7,507	1,951,529
CASH AND CASH EQUIVALENTS— End of year	\$ 89,756	\$ 50,166	\$ 2,352,503	\$ 16,250	\$ 2,508,675	\$ 101,212	\$ 47,713	\$ 1,923,830	\$ 12,876	\$ 2,085,631

UNIVERSAL SERVICE ADMINISTRATIVE COMPANY

NOTES TO FINANCIAL STATEMENTS YEARS ENDED DECEMBER 31, 2003 AND 2002 (In thousands)

4. INCOME TAXES

USAC is a not-for-profit organization subject to income taxes related to permanent and temporary differences such as meals and entertainment expense and financial accounting versus tax depreciation. Income taxes for 2003 and 2002 are not material and are included as a component of administrative costs.

5. INTERPROGRAM TRANSFERS

On June 13, 2002, the FCC released Docket No. 02-6, directing USAC to apply unused Schools and Libraries Support Mechanism funds to stabilize the USF contribution factor. Based upon projected demand and projected contributions, USAC transferred unused Schools and Libraries Support Mechanism funds to the other Support Mechanisms in 2002 and first quarter of 2003.

6. COMMITMENTS AND CONTINGENCIES

Commitments to Schools, Libraries and Rural Health Care Facilities—The management of USAC has developed operational procedures to administer the application process through which eligible schools and libraries and rural health care providers apply for universal service funding. These operational procedures enable USAC to review and process applications resulting in funding commitment letters that are issued to eligible schools and libraries and rural health care providers. Funding commitments made to eligible schools and libraries and rural health care providers are not fixed and are not binding for either USAC or the schools and libraries and rural health care providers applying for funding. At any point in time, funds committed could potentially exceed funds available due to the nature of the process, the volume and timing of application receipt and approval, the timing of collections and the extent to which several funding years may be open at that point in time. USAC also receives funds returned by service providers and applies those funds to reduce the disbursements against commitments to schools, libraries, and rural health care providers.

Fixed Contract Commitments

IBM Agreement—On May 10, 2001, USAC entered into an agreement with PricewaterhouseCoopers Consulting, LLP (“PwC”) (the “PwC Agreement”) for billing, collection and disbursement services for USAC. The PwC Agreement was a five-year contract, for the period July 1, 2001 to June 30, 2006. On October 1, 2002, IBM Consulting (“IBM”) purchased PwC, resulting in an assignment of USAC’s contract to IBM (“IBM Agreement”). In January 2003, the FCC directed USAC to terminate the IBM Agreement due to IBM’s acquisition of PwC. USAC’s board of directors approved a course of action to negotiate a termination of the IBM Agreement and develop a plan to perform the billing, collection and disbursements in house. On June 1, 2003, USAC and IBM agreed to terminate the prior agreement and entered into a restated agreement for transition services through February 2004. During 2003, USAC began to perform the billing, collection and disbursements in house.

UNIVERSAL SERVICE ADMINISTRATIVE COMPANY

NOTES TO FINANCIAL STATEMENTS YEARS ENDED DECEMBER 31, 2003 AND 2002 (In thousands)

The following amount represents the full contractual obligation due under the IBM Agreement in effect at December 31, 2003:

Year Ending December 31, 2004	\$ 725
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LaSalle Bank Agreement—On May 1, 2001, USAC entered into an agreement with LaSalle Bank (“LaSalle Agreement”). The LaSalle Agreement is a five-year contract, which runs from July 1, 2001 to June 30, 2006. Under the terms of the LaSalle Agreement, LaSalle provides banking and investment management services for a fixed annual contractual amount that may be satisfied by fees derived by LaSalle from the investment of a portion of the custodial assets. LaSalle has also agreed to share with USAC the fees it earns for managing the investments after the annual fee has been satisfied. In accordance with the LaSalle Agreement, USAC accrued fees of \$2,756 and \$2,088 for the years ended December 31, 2003 and 2002, respectively, which is reflected as a reduction in operating expenses in the accompanying financial statements. The fees earned are dependent on the amounts invested and vary over the term of the contract. Because USAC’s contract with IBM terminated in February 2004, the nature of USAC’s contract with LaSalle has changed. Consequently, USAC has determined that it would be more appropriate to recognize the fixed annual contractual amount with LaSalle as a billing and collection expense and the fees earned in excess of those used to satisfy the contractual amount as investment income in 2004 and beyond. This accounting change was implemented in first quarter 2004.

The future contractual required payments per year under the LaSalle Agreement are as follows:

2004	\$ 974
2005	1,027
2006	528

NECA Services Inc. Agreement—On May 1, 2000, USAC entered into an agreement with NECA (“NECA Agreement”). The NECA Agreement was a three-year contract, which ran from July 1, 2000 to June 30, 2003. Effective July 1, 2002, the NECA Agreement was amended and extended to June 30, 2005, with renewal options through June 30, 2008. Under the terms of the new agreement, NECA is to provide programmatic support service to the Schools and Libraries and Rural Health Care Support Mechanisms. Effective January 1, 2003, the contract was assigned to NECA Services Inc. (“NSI Agreement”). The future contractual required payments per year through June 30, 2005 under the new NSI Agreement are as follows:

	<u>Schools and Libraries</u>	<u>Rural Health Care</u>
2004	\$ 31,497	\$ 2,558
2005	16,686	1,343

Telcordia Agreement—On September 2, 2003, USAC entered into an agreement with Telcordia Technologies, Inc. (“Telcordia Agreement”). The Telcordia Agreement is a five-year contract with a four-

UNIVERSAL SERVICE ADMINISTRATIVE COMPANY

NOTES TO FINANCIAL STATEMENTS YEARS ENDED DECEMBER 31, 2003 AND 2002 (In thousands)

month transition phase that runs from September 2, 2003 to December 31, 2008, with a renewal option for one year. Under the terms of the agreement, Telcordia is to provide programmatic support services to the High Cost and Low Income Support Mechanisms. The future contractual required payments per year through December 31, 2008 under the Telcordia Agreement are as follows:

2004	\$ 4,674
2005	4,136
2006	4,000
2007	3,888
2008	3,975

Lease Commitments—USAC leases its office space under two operating lease agreements expiring at various dates through December 2013. At December 31, 2003, the future minimal rental payments under these leases are as follows:

2004	\$ 967
2005	982
2006	1,005
2007	1,027
2008	1,050
Thereafter	5,719

Rent expense under operating leases was \$716 and \$330 for the years ended December 31, 2003 and 2002, respectively.

Legal Disputes—The Company is involved in various legal proceedings and claims incidental to the normal conduct of its business. Among other matters, the Company was named as a third-party defendant in a judicial proceeding in the Commonwealth of Puerto Rico asserting the claim that a Schools and Libraries Universal Service Support Mechanism funding commitment was a binding contract breached by the Company. The third-party plaintiff, who failed to exhaust its administrative remedies as required by law, seeks \$70 million in unspecified damages. The Company was also named as a defendant in a complaint in the United States Bankruptcy Court for the Northern District of Illinois seeking to avoid allegedly wrongful transfers under the Bankruptcy Code and to recover approximately \$3.7 million in universal service contributions. The Company believes the allegations in the complaints are without merit and is defending these matters vigorously. Although it is impossible to predict the outcome of these or any of the other outstanding legal proceedings involving the Company, the Company believes that such outstanding legal proceedings and claims, individually and in the aggregate, are not likely to have a material effect on its financial position or results of operations.

UNIVERSAL SERVICE ADMINISTRATIVE COMPANY

NOTES TO FINANCIAL STATEMENTS YEARS ENDED DECEMBER 31, 2003 AND 2002 (In thousands)

7. RETIREMENT PLANS

USAC has a 401(k) Retirement Savings Plan covering all USAC regular employees. The plan is both contributory and noncontributory and all contributions are subject to certain limitations as prescribed by the plan document and government regulations. Employees are immediately vested in the employer contribution, which is funded on a current basis. Employer contributions charged to operations was \$663 and \$439 during 2003 and 2002, respectively.

8. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In June and August 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 143, *Accounting for Asset Retirement Obligations*, and No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, respectively. SFAS No. 143, which was effective for the Company on January 1, 2003, requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. The adoption of SFAS No. 143 did not have a material impact on the Company's financial position, operations or cash flows. SFAS No. 144, which was effective for the Company on January 1, 2002, supersedes current accounting literature and now provides for a single accounting model for long lived assets to be disposed of by sale and discontinued operations presentation. The adoption of this statement did not have a material effect on the Company's financial statements.

In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. This standard nullifies Emerging Issue Task Force (EITF) Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*. This standard requires the recognition of a liability for a cost associated with an exit or disposal activity at the time the liability is incurred, rather than at the commitment date to exit a plan as required by EITF 94-3. The Company adopted this standard effective January 1, 2003. The adoption of SFAS No. 146 did not have a material effect on its results of operations or financial position.

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